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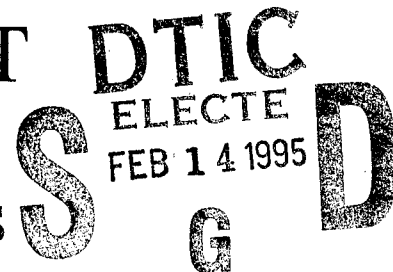
Testimony

Before the Subcommittee on Readiness
Committee on Armed Services
House of Representatives

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FINANCIAL
MANAGEMENT

Defense Business
Operations Fund
Implementation Status



Statement of Donald H. Chapin
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Mr. Chairman and Members of the Subcommittee:

We are here today to present our views on Defense's progress in planning and implementing the Defense Business Operations Fund. We and Defense are in full agreement that the concept and goals of the Fund are worthwhile. Applying businesslike management practices should substantially improve Defense's \$81 billion operations under the Fund.

The potential benefits of the Fund are enormous. Its primary goal is to focus the attention of all levels of management on the cost of carrying out Defense operations and the management of those costs. Specific benefits of the Fund include the following:

- (1) setting Fund rates to recover full costs should make Defense managers more aware of, and help reduce, these costs,
- (2) identifying the full costs of providing the Fund's goods and services, and measuring performance on the basis of cost goals, should help reduce the operating costs of the Fund's 360,000 person organization,
- (3) consolidating cash control in Defense should help reduce the amount of cash needed to operate the Fund, and
- (4) providing better information on business operations should allow for more informed policy decisions by Defense management and the Congress as Defense adapts to the new world environment.

Accomplishing these objectives would mark a fundamental improvement in the manner in which Defense conducts business.

However, achieving these benefits will be difficult, time-consuming, and a favorable outcome is by no means assured. Defense must adopt workable policies that are fully consistent with businesslike practices. Existing systems used to manage and control resources must be substantially upgraded, and effective new systems must be developed and implemented. If these steps are not taken expeditiously, the business concepts of the Fund may be discredited and the opportunity to make this fundamental change in the management of Defense will be jeopardized. Further, the quicker these steps can be taken, the sooner the cost-saving potential of the Fund will be realized.

In our view, progress to date has been slow. Key policies and systems have not been developed as rapidly as they should have been. At this point, Defense's top management needs to ensure that sufficient expertise and resources are being applied and that the efforts of the various organizations involved in the effort are properly supported and coordinated.

BACKGROUND

In October 1991, Defense implemented the Defense Business Operations Fund, which consolidated the nine existing industrial and stock funds operated by the military services and Defense as well as the Defense Finance and Accounting Service (DFAS), the Defense Industrial Plant Equipment Services, the Defense Commissary Agency, the Defense Reutilization and Marketing Service, and the Defense Technical Information Service.

For fiscal year 1993, Defense estimates that the Fund will have sales of goods and services of about \$81 billion. When compared to the sales reported by Fortune magazine's global 500 industrial corporations, the sales would make the Fund equivalent to the fifth largest corporation in the world--exceeded only by General Motors, Royal Dutch/Shell Group, Exxon, and Ford. Defense also estimates that the Fund will employ about 360,000 civilian and military personnel and have assets valued at about \$126 billion during fiscal year 1993.

In considering Defense's fiscal year 1992 budget, the Congress expressed concerns similar to those discussed in our April 1991 testimony about Defense's establishment and operation of the Fund. Due to these concerns, the National Defense Authorization Act for Fiscal Years 1992 and 1993 authorized the Fund only through April 15, 1993. The Congress also prohibited Defense from including any new activities in fiscal year 1993, so that it could evaluate the Fund's performance before any further expansion. The conference report, which accompanied the act, directed Defense to provide the Fund's overall policy, implementation plans, and management performance factors to the congressional Defense committees and to us by January 1, 1992. The conference report also directed us to report to the congressional Defense committees on the Fund no later than June 15, 1992.

DEFENSE IS REVISING ITS IMPLEMENTATION PLAN

As directed by the Congress, Defense has prepared an implementation plan for the Fund. In February 1992, we advised Defense that the plan was not structured and detailed enough to show specifically how the Fund will achieve its goals. Acting upon our suggestions, Defense is revising the plan. We have reviewed a draft of the revised plan and found it to be much improved. The draft provides details on the specific actions that need to be performed, the various Defense components that are responsible for performing those tasks, and specific time frames for their completion.

A plan is only the first step in a long process. Achieving the Fund's goals and objectives will require a sustained commitment from top management for several years. At this time only a limited number of changes have been implemented. Defense management should closely monitor the existing milestones in order to keep the plan on course and should set additional milestones when the policies and programs are finally in place.

PROGRESS MADE IN DEVELOPING POLICIES

In our April 1991 testimony before this Subcommittee, we pointed out that Defense had not developed the policies to clearly explain how the Fund would operate, its controls, the rationale for including each business area, the responsibilities for financial

decision-making, and its financial management requirements. Although Defense has finalized some policies, other key policies are still under development. These policies are outlined below and discussed in further detail in appendix I.

Defense Policies Already Established

During the past year, Defense established operating and capital budgets for the Fund's activities based on the unit cost concept, and, at our recommendation, they also adopted the percentage-of-completion method for revenue recognition for industrial fund activities. However, we disagree with three other Defense policies, two of which will result in the Fund's customers' appropriations being unnecessarily charged about \$760 million in fiscal year 1993.

First, Defense plans to increase prices to recover \$454.8 million in accumulated operating losses. Defense should not be permitted to raise future Fund's prices to cover prior year losses. Rather, Defense should be required to justify recovering prior year losses as part of the appropriation process so that the Congress would have an opportunity to review the Fund's operations and determine the reasons for the losses.

Second, the fiscal year 1993 prices would include \$305 million in military construction (MILCON) depreciation costs. Since MILCON projects are being funded by MILCON appropriations, not the Fund, the prices set by Defense are inappropriate. These projects are being funded twice--once through the MILCON appropriation and once through the higher prices charged the customer. As discussed in last year's testimony, we believe it would be more appropriate for MILCON projects to be funded through the Fund and approved by the Congress.

Third, Defense has developed a policy for major real property maintenance and repair projects which would average the estimated costs for these projects over a 10-year period. This is aimed at avoiding annual fluctuations in the prices charged customers. We believe this policy is not a sound business practice nor is it in accordance with generally accepted accounting principles.

Key Policies Still Being Developed

Defense has not yet finalized other key policies involving cash management, capital asset accounting, and intrafund transactions that are needed to help account for, control, and report on tens of billions of dollars of resources.

First, a cash management policy is needed to prescribe the minimum and maximum amounts of cash the Fund needs to operate efficiently. At the end of March 1992, the Fund's cash balance was \$5.9 billion.

Cash forecasting is critical because as the force structure decreases, the cash needs of the Fund should also decrease.

Also, to improve cash management of the Fund, the Congress may want to enact legislation providing the Fund with contract authority for capital projects. This concept would not be new to Defense since stock funds have operated under contract authority to maintain stock levels for many years. A Defense budget official stated that if the Fund had contract authority for capital items, the Fund would need only \$532 million, rather than \$1.4 billion, in cash at the end of fiscal year 1993 to cover capital outlays to be made early in fiscal year 1994.

Second, a policy is needed to account for, control, and report on capital assets, which Defense estimates will be \$20.2 billion at the end of fiscal year 1993.

Third, a policy is needed to account for and record \$19 billion in intrafund transactions, which represent approximately 23 percent of the Fund's business. Defense needs procedures to clearly detail how these "transfers of costs" and the "recognition of revenue" will eliminate the recording of various account balances, such as cash, accounts receivables, and accounts payables.

LIMITED PROGRESS MADE IN DEVELOPING ACCURATE AND RELIABLE COST ACCOUNTING SYSTEMS

Defense has made little progress in improving the existing cost accounting systems used by the stock and industrial funds and is still in the process of determining the requirements for the Fund's cost accounting systems. While Defense's Corporate Information Management (CIM) initiative initially appeared to be a promising undertaking, improved systems resulting from the initiative will not be implemented for years. Despite the limitations and deficiencies of the existing systems, Defense can do much to improve the quality of the financial information these systems produce in the short term. While Defense is primarily relying on long-term solutions, we believe strong actions are needed now to achieve improvements.

Standard Cost Accounting System Has Not Been Selected

In early 1991, DFAS initiated two projects to study the various stock and industrial fund accounting systems and make recommendations to improve the systems. Although DFAS developed an inventory of systems, no other tasks were completed and work was suspended in late 1991. In February 1992, DFAS decided to combine the stock fund and industrial fund initiatives into an ongoing study to select a Defensewide standard general accounting and funds distribution system. As of March 1992, DFAS had not yet developed an implementation plan or specified the boundaries of the project.

Nor had DFAS set any milestone dates for the initiative, except for selecting the standard system(s) for industrial and stock fund activities in early 1993. Accurate, reliable, and informative cost information is absolutely essential to achieving the Fund's goals. At present, DFAS has no systematic and reliable way to produce this cost information.

To improve the information needed to control cost and set prices, we believe that Defense needs to have a standard cost system using predetermined standards. The integrated standard cost systems used by large manufacturing and distribution organizations could provide models for Defense. Defense needs to identify requirements for this type of cost accounting system soon so that it can begin developing such a system for this fundamental part of the Fund. Available commercial software should be considered to reduce the implementation time and begin to obtain accurate cost information in the near term.

APCAPS May Not Meet the Fund's Needs

Fund activities that did not have a cost accounting system--primarily the military services' stock funds which account for \$29 billion--have been directed to use the Automated Payroll, Cost Accounting, and Personnel System (APCAPS). DFAS has identified several enhancements that need to be made to APCAPS to meet the Fund's requirements, including the following: (1) reporting costs rather than obligations for unit cost purposes, (2) providing additional equity accounts, such as net operating results and accumulated operating results needed to measure the Fund's performance, and (3) adding a capability for capital asset accounting, which is a new requirement under the Fund.

Furthermore, accounting officials at DFAS-Centers have stated that the usefulness of reports generated from APCAPS is limited. The reports are (1) not timely, (2) sometimes inaccurate, (3) at too high an organizational level, and (4) insufficiently detailed to evaluate the performance of individual managers within an organization.

FULL DISCLOSURE OF FUND CHANGES NEEDED FOR ACCURATE FINANCIAL REPORTING

In implementing the Fund, Defense significantly changed its management philosophy and practices for operating industrial and stock funds. However, Defense did not fully disclose and explain the effect of these changes, including their impact on customers' appropriations, in its 1992 Fund overview book. Two of these financial reporting issues involve prices charged customers for stock fund items and adjustments made to financial reports.

First, starting in fiscal year 1993, Defense plans to charge customers the total cost of items sold and eliminate the surcharge for maintaining a certain level of cash with the Treasury. The proposed changes resulted in Defense requesting an additional \$300 million for customers' appropriations. Defense officials told us that they changed this policy to more accurately reflect the actual cost incurred by the stock fund. While we agree that this policy is in keeping with the concept of the Fund, we believe Defense should fully disclose and explain policy changes affecting customers' appropriations.

Second, Defense decided to eliminate \$3.1 billion in supply operations' accumulated operating losses. According to Defense officials, this was done because past stock fund prices were set to meet a certain cash objective and mistakes were made in reporting the \$3.1 billion as an accumulated loss last year. However, the overview book does not provide any information specifying that the \$3.1 billion in accumulated operating losses was eliminated. Adjustments of this magnitude should be fully disclosed and explained so that the Congress will have the information it needs to exercise its oversight responsibilities over the Fund and its customers' appropriations.

CONCLUSIONS

We continue to support the overall objective and concept underlying the Defense Business Operations Fund. The Fund could make an important contribution to improving Defense's business operations and financial management. For this reason, Defense needs to minimize risks that might cause the Fund to fall short of its objectives.

Successful implementation of the Fund will require continued commitment from Defense's top management to (1) plan realistically and ensure that management expertise and staffing levels are sufficient, (2) place a high priority on financial management, including developing performance indicators, (3) fully disclose the financial results of operations, (4) commit to enhancing existing financial systems in the short term to improve the accuracy of financial data and develop and implement new systems much more effectively than in the past, and (5) develop a cost-conscious culture by considering cost as well as readiness implications in the decision-making process. While this will not be easy, it is absolutely required to realize the expectations Defense has established for the Fund. Defense needs to demonstrate measurable progress and show that it can operate Fund activities more efficiently than in the past.

Reliable cost information is crucial to ensuring that the right decisions are made and to measuring and verifying the impact of these decisions. Managers must have accurate costs in order to establish realistic goals and to measure actual performance against

those goals. Unit cost goals, based on accurate data, can be a meaningful performance measurement to evaluate how effectively the Fund is operating.

Although accurate cost data are critical to the Fund's success, little progress has been made in developing a standard cost accounting system to provide these data. DFAS is initiating an effort to select such a system, but it has yet to develop a comprehensive plan to guide its efforts. DFAS needs to establish milestone dates to complete the various tasks. Control and accountability must be established because Defense cannot afford failures.

Meaningful and reliable financial reports including the Fund's budget presentation are essential for the Congress to exercise its oversight responsibilities. Financial reports would highlight critical information, such as the significance of the Fund's cash balance, inventories, and capital projects. The financial reports could also be used to develop trends, make comparisons, and provide a basis for evaluating the Fund's performance.

Further, Defense is primarily relying on the CIM initiative to provide long-term solutions to its financial management problems. Defense needs to pursue efforts to make short-term improvements in internal controls and the quality of financial data in existing systems and gain early benefits. Effective management of the Fund's activities and resources is now impaired because these improvements have not been made.

Since Defense has made only limited progress in developing and implementing key policies and systems, we believe that the "sunset provision" called for in the National Defense Authorization Act for Fiscal Years 1992 and 1993 should be extended through the end of fiscal year 1994 and that Defense should not be permitted to add any new activities in fiscal year 1994. This should provide Defense time to (1) develop and implement its policies and procedures, (2) develop and implement systems that provide accurate and reliable cost data, and (3) show how the Fund has reduced costs in providing goods and services to its customers. Because of the fiscal and budgetary importance of the Fund, we believe that the Congress should closely monitor its operation. Until the benefits of the Fund are convincingly demonstrated, we believe that the Congress should refrain from permanently authorizing the Fund.

Mr. Chairman, this concludes my statement. We will be pleased to answer questions you or other members of the Subcommittee may have at this time.

DEFENSE POLICIES ISSUED OR BEING DEVELOPED ON
ACCOUNTING AND BUDGETING FOR THE FUND

POLICIES ISSUED ON THE FUND

During the past year, Defense established operating and capital budgets for the Fund's activities on the basis of the unit cost concept. Defense also adopted the percentage-of-completion method to recognize revenue for industrial fund activities. However, we have concerns with three other Defense policies, two of which will result in the customers' appropriations being unnecessarily charged about \$760 million in fiscal year 1993.

Budgets Provided to Fund's Business Areas

In September 1991, Defense issued operating and capital budgets for the Fund's fiscal year 1992 business areas. The operating budgets provide the total cost authority required to support a Fund activity's operations, based on actual work to be performed. The capital budgets reflect the Fund's obligation authority for the acquisition of capital assets. Each military service and Defense activity is expected to allocate the annual cost authority to the activities within a business area. For example, the Naval Air Systems Command is responsible for allocating the budget to each aviation depot.

Defense Revised Its Policy
on Revenue Recognition

In January 1992, in response to our report,¹ Defense revised its policy on revenue recognition for industrial fund activities. In the past, the industrial funds could choose between the completed contract or the percentage-of-completion method of revenue recognition. The revised policy requires that the percentage-of-completion method be used for work that is expected to be completed in a fiscal year other than the one in which the work was started. The implementation of this policy will ensure consistency in the recognition of revenue and ensure that the operating results reported in the financial statements are comparable between business areas.

Recovery of Accumulated Operating
Losses Inappropriate

¹Management letter to the Comptroller, Department of Defense (GAO/AFMD-92-5ML, October 22, 1991).

Defense has estimated that the Fund will have a \$454.8 million accumulated operating loss at the end of fiscal year 1992. For fiscal year 1993, Defense plans to adjust the prices the Fund will charge customers to recover these accumulated operating losses. Accumulated operating results are the sum of all annual results of operation since the inception of the activity, whereas net operating results apply only to the current fiscal year of operations.

To operate the Fund in a businesslike manner, the prices charged customers should reflect the cost incurred in providing the goods and services. Increasing prices to cover past losses diminishes the incentive for the Fund to operate efficiently and makes it difficult to evaluate and monitor the status of the Fund. The Fund should not be permitted to raise prices to cover prior year losses. The Fund, not the customers, should be required to request additional funds through the congressional appropriation process.

The requirement to request additional funds from the Congress to make up for losses would give the Congress an opportunity to review the Fund's operations, determine the reasons for the losses, and evaluate the effectiveness of Defense inventory management, including its effort to reduce excess inventories. In essence, the need to request additional funds would inform the Congress on how efficiently the Fund is being managed.

Proposed Fund Prices Inappropriately Include
Military Construction Depreciation Costs

Defense included Fund-related military construction (MILCON) projects in its original proposal to establish the Fund. For fiscal year 1992, Defense estimated that these projects would amount to about \$400 million. Defense planned for the Fund's MILCON amount to be funded as part of the price charged to the customers through the recovery of depreciation expense. In authorizing amounts for the Fund, the Congress decided that MILCON projects would continue to be financed through the Military Construction appropriations.

However, in developing the fiscal year 1993 prices, Defense included MILCON-related depreciation expense as part of the total costs. In total, this amounted to about \$305 million. Including depreciation expense in the prices charged customers is inappropriate since military construction projects costs are being borne not by the Defense Business Operations Fund but by the Military Construction appropriation. As a result, military construction projects are being funded twice--once through the MILCON appropriation and once through the higher prices charged the

customer. This will provide Defense with additional cash, for which there are no anticipated cash outlays.

Policy on Maintenance and Repair
Projects Needs To Be Revised

In December 1991, Defense issued guidance on accounting for major real property maintenance and repair (MRPM&R) projects costing more than \$15,000. MRPM&R projects maintain property so that it can operate efficiently, but do not expand its usefulness or capability. For example, replacing a roof would be classified as such a project. These projects are not treated as capital assets and are not depreciated. For fiscal year 1993, Defense has estimated that it will spend about \$589 million on these projects.

To finance these projects, the Fund will receive an annual budget which will specify a monthly amount to be expensed. In accounting for the projects, amounts are to be recorded in the accounting records and accrued as an expense for which the actual outlay has already occurred or will occur in the future. In determining this amount, Defense activities are to average the estimated costs for these projects over a 10-year period. The stated purpose of recording this monthly amount is to avoid annual fluctuations in recorded MRPM&R expenses of a business area.

Defense's policy is not in accordance with generally accepted accounting principles which require recording costs in the accounting period in which the cost is incurred. Defense's policy would recognize expenses before or after they are incurred in an attempt to equalize annual operating costs year to year. By not using accrual accounting, Defense could impair the integrity of the financial statements, and the statements could be misleading.

POLICIES STILL BEING
DEVELOPED FOR THE FUND

While Defense has developed some policies, it has not yet finalized other key policies critical to the Fund's operations. These policies are needed to help account for, control, and report on tens of billions of dollars of resources.

Cash Management for Operations

Defense is developing a policy for managing the Fund's cash balance. This policy will need to prescribe the minimum and maximum amounts of cash the Fund needs to operate efficiently. To manage the Fund's cash balance, Defense currently receives weekly reports on collections and disbursements which are used to determine the Fund's cash trends. At the end of March 1992, the

weekly report showed that the Fund's cash balance was \$5.9 billion. According to the Defense Business Operations Fund overview book, this is about \$1.8 billion higher than the \$4.1 billion estimated cash balance at the end of fiscal year 1992. Defense officials stated that they believe the Fund will disburse at least \$1.8 billion more than it receives between now and the end of the fiscal year and reduce this surplus of cash. Further, Defense estimates that the cash balance at the end of fiscal year 1993 will be approximately \$3.7 billion.

Defense officials believe that once better systems are in place, they will be able to determine the amount of cash needed to operate the Fund. In addition, Defense officials stated that when Defense consolidated the cash into a single Fund balance, the cash data reported in the components' official financial systems could no longer be reconciled with the cash balance at Treasury. If an error occurs, Defense does not have an audit trail to determine which business area is responsible for the error in the amount of cash reported to Treasury. Defense is currently developing an audit trail to correct this problem.

Cash Management for Capital Projects

The Fund's capital budget for fiscal year 1993 is estimated to be about \$1.4 billion. The capital budget includes investment in equipment, minor construction, and management information systems costing more than \$15,000. Capital budget investments are funded through either surcharges or an amount for depreciation added to the prices charged customers. The Fund's capital program mirrors the former Asset Capitalization Program (ACP) used by Defense industrial funds. We have previously reported on the weaknesses in Defense's management of the ACP program.

With the establishment of the Fund, Defense has improved the financial management of its capital projects. Funds for capital projects are set aside in reserve, which is in line with our previous recommendation. According to Defense, the cash balance in reserve will be sufficient at all times to cover unliquidated obligations. However, the cash will remain essentially idle while the Fund awaits delivery of capital items, which could take several years. For example, at the end of fiscal year 1993, Defense estimates the cash reserve will have a balance of \$1.4 billion to cover unliquidated obligations for capital projects.

To improve cash management of the Fund, the Congress may want to give the Fund contract authority for capital projects as an alternative to maintaining these idle cash balances. This concept would not be new to Defense since stock funds have operated under contract authority for many years.

Contract authority would allow the Fund to award contracts for capital projects without having to maintain the full amount of cash for capital projects in the Fund. By using contract authority, the Fund would only need to have cash available to pay the required outlays for capital projects. A Defense budget official stated that the Fund would need only \$532 million in cash at the end of fiscal year 1993 to cover outlays to be made early in fiscal year 1994.

This proposal would not alleviate Defense's responsibility to maintain cash in reserve for the capital projects. Further, in preparing the budget for capital projects, Defense should display information in the Defense Business Operations Fund overview book on the (1) total amount to be obligated for the capital projects and (2) estimated amount to be disbursed against those capital projects by fiscal year. In addition, the budget should explain how the capital projects will improve the Fund's operation and thereby reduced its overall costs.

Capital Asset Accounting

Defense is developing policy on accounting for, controlling, and reporting on capital assets. According to the February 1992 Defense Business Operations Fund overview book, the capital property balance at the end of fiscal year 1993 will be about \$20.2 billion. DFAS officials stated that once the capital asset policy is issued, Fund activities will not be able to fully comply immediately because (1) capital assets were not consistently depreciated within the Department in the past and (2) there is no standard methodology to depreciate capital assets. This could adversely affect the Fund's ability to determine the net value of capital assets for its fiscal year 1992 financial statements.

Intrafund Transactions

Defense has not issued guidance on recording and accounting for \$19 billion in intrafund transactions. Defense has indicated that approximately 23 percent of the Fund's operations will result from transactions among business areas. When a business transaction occurs among the Fund's various businesses, Defense has indicated that a "bill" will not be issued. Rather, the cost will be transferred within the Fund. Defense's policy needs to clearly detail how this "transfer of cost" and "recognition of revenue" will eliminate the recording of various account balances, such as cash, accounts receivable, and accounts payable for individual activities.

Standard Policies Needed
for Repairable Inventory Items

We reported in June 1991² that Defense had not taken steps to ensure that uniform policies were developed and implemented for the Defensewide initiative to finance repairable items through the stock fund. Specifically, Defense has allowed the services to implement differing policies related to (1) the prices that the stock funds will charge customers for repairable items and (2) the ownership and control that the stock funds will have over repairable items at the installations. The lack of uniform policies will preclude uniform financial reporting by the military services' stock funds and undermine Defense's efforts to standardize systems under the CIM project, which is intended to improve financial and management information systems and reduce operational redundancies. Defense is in the process of resolving this issue.

²Financial Management: Uniform Policies Needed on DOD Financing of Repairable Inventory Items (GAO/AFMD-91-40, June 21, 1991).

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